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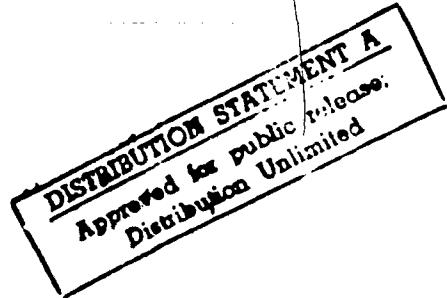
**MANAGEMENT OF CONTRACT  
FINANCE POLICY**

January 1977

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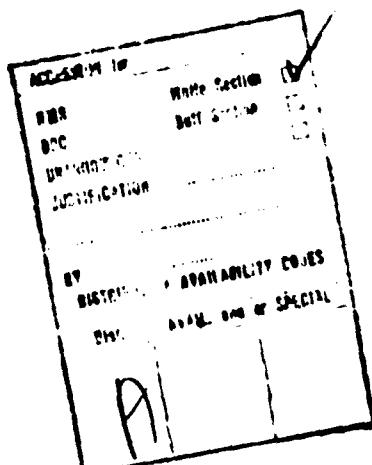
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## I. INTRODUCTION

This report is in response to Task 76-10, "Management of Contract Finance Policy." The task was initiated in early 1976 by the Principal Deputy Assistant Secretary of Defense (Installations and Logistics). The objective was to define and delineate responsibilities falling under the Assistant Secretary of Defense (Installations and Logistics) (ASD(I&L)) in the area of contract finance policy and to recommend appropriate changes. Specifically, the task called for the formulation of a mission statement for the Directorate of Contract Finance and operating guidelines for the Contract Finance Committee.

The LMI study effort for Task 76-10 consisted of three principal subtasks. The first was a thorough review of the historical and current operations of the management of contract finance under the ASD(I&L). An attempt was made to locate and interview individuals who have held key jobs in this area during the past twenty years. Through discussions with these people, we gained an understanding of how the contract finance function was handled in the past and how the current structure evolved.

To acquire a detailed understanding of the present operation, interviews were conducted with those individuals who now hold positions of responsibility in the area of contract finance. This group included all the members of the Contract Finance Committee, the staff of the Directorate of Contract Finance Policy, and the Deputy Assistant Secretary of Defense (DASD) (Procurement) and his staff. Interviews were also conducted with DoD representatives in field locations to ascertain how problems and issues arise and when responsibility for resolving them is assumed by the Office of the Secretary of Defense (OSD) rather than the military departments (MILDEPs).

The second subtask was to analyze the current contract finance organization and to devise alternatives and solutions. This effort included a study of such documents as pertinent Department of Defense (DoD) directives, the Armed Services Procurement

Regulation (ASPR), and mission statements for various groups. Additionally, meetings were held with individuals working in contract finance, as well as other interested parties within and outside of the DoD in order to hear their evaluations of the current organization and possible alternatives.

The final part of the task was an identification of alternative organizational structures for the contract finance function outside the MILDEPs, and recommendation of the most effective structure.

## II. CURRENT ORGANIZATION FOR MANAGING THE CONTRACT FINANCE FUNCTION

Responsibilities for the administration of contract financing currently are divided between the ASD(I&L) and the MILDEPs. Responsibilities are allocated to the two groups by Appendix E of the ASPR.<sup>1</sup> Basically, all policy and important procedural problems come under the aegis of the ASD(I&L) while the MILDEPs handle day-to-day financing matters.

Historically, the ASD(I&L) has carried out his contract finance responsibilities through the Chairman of the Contract Finance Committee. In January, 1975, the Directorate of Contract Finance was established to support the Chairman. The Chairman served as the Director of Contract Finance Policy and has been the Assistant Secretary's spokesman on policy matters relating to contract finance. He has continued to preside over the Committee, which resolves problems and issues which cannot be concluded by the MILDEPs.

The MILDEPs resolve most routine problems relating to contract finance. However, when a case involves a deviation from (rather than an interpretation of) Appendix E regulations, the case must be acted upon by the Contract Finance Committee.

### CONTRACT FINANCE COMMITTEE

The Contract Finance Committee was established on 30 October 1953 by DoD Directive 7200.1. The basic mission of the Committee was to achieve uniformity in the administration of contract financing. Operating under the aegis of the ASD(Comptroller), the Committee was made up of four to six members who functioned in a relatively informal manner. The work of the Committee was focused primarily on the

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<sup>1</sup> Appendix E of the Armed Services Procurement Regulation sets out regulations for defense contract financing (except in shipbuilding and construction).

administration of V loans;<sup>2</sup> very seldom were day-to-day financing problems of the MILDEPs brought to the Committee.

In 1962, the Committee was transferred from the ASD(Comptroller) to the ASD(I&L). Since coming under the jurisdiction of the ASD(I&L), the Committee has grown in size to its current nine member composition. The ASPR now requires two representatives from each of the MILDEPs, at least one from the OASD(Comptroller) and two from the Defense Logistics Agency. The Committee also includes an advisor from the Defense Contract Audit Agency. The increased size corresponds to the increase in volume and complexity of the tasks and responsibilities assigned to the Committee.

The following case is typical of the work undertaken by the Committee:

**Case 76-16: CAS Relationship to Progress Payments.**

CAS<sup>3</sup> 410 requires contractors to allocate general and administrative (G&A) expense to DoD work on a consistent basis. However, some contractors use a cost input G&A allocation base for computing progress payments and cost-of-sales allocation base for computing final cost.

This case raised the issue of the applicability of CAS to progress payments in addition to calling for a technical interpretation. Because some contractors might have to refund certain improperly billed charges, the case was sensitive. The Committee reached a decision that G&A allocation should be consistent for the computation of both cost and progress payments.

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<sup>2</sup>This form of contract financing is comparable to the guaranteed loans allowed under the ASPR today. The two other allowable forms of contract financing are progress payments and advance payments.

<sup>3</sup>CAS refers to a cost accounting standard (or standards) promulgated by the Cost Accounting Standards Board.

This case is a clear example of a problem beyond the authority of the MILDEPs. Their authority does not apply to this case because:

- The problem encompasses progress payments on a large number of contracts in all MILDEPs.
- Resolution of the problem would require new ASPR policy.
- Resolution of the problem would require a DoD response to another government agency.

Overall, the Committee's cases fall into two major categories. The first category includes cases submitted by the MILDEPs for deviations from Appendix E. These occur when a MILDEP concludes that a contract financing decision requires deviation from Appendix E rather than interpretation which the MILDEP, itself, can make. From time to time, a MILDEP submits a crucial case to the Committee in order to gain its backing and support, even though the case could be settled by the MILDEP. A Committee member from the originating MILDEP presents the case and acts as the advocate of his MILDEP's position. After consideration of the merits, the Committee decides the case by majority vote.

The other category includes cases in which the Committee deliberates and recommends changes in contract finance regulations, to be set out in ASPR, Appendix E. The Contract Finance Committee's recommended changes, after approval, are sent to the ASPR Committee for publication. The administration of contract financing has been established outside the ASPR Committee structure because it requires a higher degree of specialization. All other parts of the ASPR are administered and changed directly by the ASPR Committee.

In recent years, the work of the Contract Finance Committee has been concentrated on cases requiring deviation. The urgency and high volume of such cases has so absorbed the Committee that little has been done on general policy matters. Many persons experienced in the contract finance function believe that a complete rewrite of Appendix E now is needed.

### DIRECTORATE OF CONTRACT FINANCE POLICY

The considerable increase in workload and scope of responsibility of the Contract Finance Committee led to establishment of the Directorate of Contract Finance Policy in January 1975. The Directorate was formed to provide a staff for the Chairman of the Contract Finance Committee (CFC).

In the rush to provide support to the Chairman of the CFC, no firm boundaries of responsibility were set for the Directorate. With no charter, the Directorate has become the OASD(I&L) "catch all" for contract finance and related issues. Effective management was largely precluded. It is surprising that the Directorate has been able to complete several complex tasks over the past year-and-a-half. For example, financial analyses were conducted of several large DoD suppliers with impending financial problems, and the financial posture of the shipbuilding industry was assessed. Both of these efforts involved crucial issues that bear directly on procurement policy.

The Directorate is staffed with the following personnel: Director (Air Force Colonel), Deputy Director, Procurement Analyst Trainee, and two administrative personnel. It would be inappropriate to assess the adequacy of this level of staffing until the organizational boundaries of the Directorate are established more precisely.

### AREAS OF CONTRACT FINANCE NOT UNDER THE ASD(I&L)

There are two major areas which fall outside the jurisdiction of Appendix E of the ASPR.<sup>4</sup> The first is shipbuilding and military construction contracts. The basis for billing on those contracts is stage of physical completion rather than cost incurred. Shipbuilding contract finance questions are handled by the Navy's Banking and Finance Office; those on military construction are handled by the individual MILDEPs.

The second area not covered by Appendix E provisions is cost-reimbursement contracts. They are excluded because cost reimbursement is not considered contract financing. The rules and regulations governing cost reimbursement contracts are set forth in ASPR Section 15-104. Any problems which arise are handled by the MILDEPs.

<sup>4</sup>ASPR, Appendix E, Section E, Part 5, Paragraph E-500.2

### **III. PROPOSED ORGANIZATION AND FUNCTIONAL RESPONSIBILITIES:** **DIRECTORATE OF CONTRACT FINANCE POLICY**

#### **CURRENT PROBLEM AREAS**

Effective operation of the Directorate is impaired by unclear boundaries of authority and responsibility. As a consequence of this deficiency, the Directorate is bombarded with all kinds of requests for analyses, comments, reviews and so on. Lack of control over workload has led to a disorderly operation and has precluded annual planning, or any form of tight management.

During some periods, the Director has been fully absorbed by one urgent task; an example is the Lockheed freedom of information project. This pressing matter took the Director away from the business of contract finance policy, preempting other tasks and CFC activities which are among the Director's primary responsibilities.

#### **RECOMMENDATIONS FOR CHANGE**

Appendix A is a statement of "Proposed Mission for the Directorate of Contract Finance Policy." That statement sets forth areas of functional responsibility for the Directorate, as follows:

- Provide support for the Contract Finance Committee
- Evaluate Appendix E and prepare revisions as appropriate
- Monitor the financial condition of the Defense Industrial Base
- Conduct special studies initiated by or channeled through the ASD(I&L) or the DASD(Procurement)
- Respond to contract finance policy issues between ASD(I&L) and outside groups

The Directorate should be headed by a civilian director at the GS-16 or -17 level. His major responsibilities should be to supervise the work of the Directorate and maintain contact between OSD and outside groups on matters of contract finance policy. The Director should have a deputy at the GS-15 or -16 level who could be designated Chairman

of the Contract Finance Committee. That responsibility would require about 75% of the Deputy's time. Additional requirements for professional and support staff should be specified by the Director.

#### **IV. PROPOSED ORGANIZATION AND FUNCTIONAL RESPONSIBILITIES: CONTRACT FINANCE COMMITTEE**

##### **PROBLEMS WITH CURRENT ORGANIZATION**

The Contract Finance Committee is having difficulty meeting its responsibilities. This has been the case for more than two years. Our observation of the committee in action, made early in the study, revealed many specific problems. They are listed here with a brief explanation of each.

##### **Multiple Responsibilities of the Chairman**

The Chairman of the Contract Finance Committee has devoted only about 25% of his time to his work as Chairman. Other workload demands have diverted his attention. The Committee has thus suffered from this part-time leadership.

##### **Committee Members Devote Insufficient Time to Committee Work**

Members have full-time jobs in their parent organizations, thus, the committee must compete for available time. As a result, members cannot always devote enough time to committee work. To achieve and sustain high quality analysis of cases will require a commitment from the parent organizations to allocate a fixed amount of their members time to committee work.

##### **No Criteria Exist for Selection of Members**

The Committee is made up of varying GS grade levels. The backgrounds of members are not always strong in areas relevant to committee business.

##### **The Committee has no Administrative Support**

Administrative tasks, such as taking minutes at meetings and distributing material on upcoming cases, are not handled effectively. Deficiencies in performance of these seemingly minor chores impede Committee operations.

##### **The Committee Meets Irregularly**

There is no set schedule for committee meetings. Conflicts with members' other priorities occur regularly.

Resolution of Cases is Delayed

Due to the pressure of events or urgency of the problems involved, members must often attend meetings without detail knowledge of the topics to be discussed. This increases the time necessary to evaluate and resolve the cases.

Some Problems Overwhelm the Committee

Frequently, cases presented to the committee require decisions on novel accounting principles with no precedents. Complex contracting practices arise for review and decision. The knowledge necessary for timely resolution sometimes rests outside the committee. Even when the knowledge is within the committee, it is often not with the MILDEP presenting the case. The committee could be more effective if working groups were established for special problems. These groups need not be restricted to committee members.

There is no Follow-up on Decisions

The Committee does not monitor the impact of its major decisions. Hence, it foregoes learning which could help prevent recurrence of past mistakes.

ASPR Promulgation is not Timely

Committee decisions sometimes require a change to Appendix E of the ASPR. In such cases, the decisions must be expressed in a format for promulgation. This task is not being carried out expeditiously.

These are the problems that have plagued the Contract Finance Committee. Under an effective organizational structure, and with improved operating precepts, they could be alleviated.

RECOMMENDATIONS FOR CHANGE

We recommend that the organization of the contract finance function be maintained, but modified in format by the administrative changes discussed below.

First, the Committee should have a civilian Chairman, at the GS-15 or -16 level whose primary responsibility is to direct its operational and policy activities. While it is

anticipated that the Chairman would contribute to the activities of the Directorate of Contract Finance Policy, his first duty would be to the Committee.

The size and representation of the Committee membership should remain much as it is today. The membership should be formalized, however, by having individuals assigned via administrative orders. Further, a certain minimum GS grade or military equivalent should be established as a criterion for Committee membership. The GS-14 level is suggested.

The Committee should meet at a set time at regular intervals. We recommend that the meetings be bi-weekly. Some attendance requirement should also be established. Any member who missed more than a specified number of meetings over a set time should have to be replaced by the organization he represents.

Standard operating procedures should be established. It should be required that cases be received by the Chairman at least two weeks prior to a meeting for inclusion in the agenda. The Chairman should circulate copies of case material one week before a case is deliberated. He should also issue proceedings within one week of each meeting.

All Appendix E changes should be written up without delay after the Committee's decision and expedited through the approval and publishing process. The Committee should review Appendix E totally on an annual basis.

While technical support should come from the Directorate, the Committee should have its own administrative support and office space. This would provide a more orderly environment for the Committee's activities and would facilitate timely completion of work. Also, records of the Committee's operations should be maintained and organized for future reference.

The jurisdiction of the Committee should remain largely the same. We do, however, recommend the formulation of more stringent rules governing the submission of cases to the committee. Some of the current issues should be resolved in the MILDEPs because no deviations from Appendix E and no new policy are involved. It should be the responsibility

of the Chairman to pass on the appropriateness of each case that is submitted. Upon refusing a case, the Chairman should send written notification to the originating MILDEP. That MILDEP should then have a certain length of time (perhaps four weeks) to appeal the decision.

There are advantages to maintaining basically the current organizational structure. Perhaps most important, the current blend of personnel between procurement and finance, and between OSD and the MILDEPs, is retained. This appears to be an important and workable mix for the formulation and administration of contract finance policy. This mix not only provides equitable representation but also a strong system of checks and balances.

Another advantage is that centralized control over policy decisions in the area of contract finance is maintained at an appropriate level. Resolution of significant issues and maintenance of policy uniformity require high level attention.

There are some disadvantages. First, it may be difficult to effect the administrative changes outlined above because no dramatic organizational change has been recommended. Dramatic changes attract attention and, thereby, sometimes receive greater support in terms of additional staff and resources.

Second, it may be difficult to reorient the current membership of the Committee to the more structured procedures deemed necessary. We are convinced, however, that the advantages far outweigh the problems that are likely to be encountered.

Other alternatives which we considered are described in Appendix B.

## APPENDIX A

### PROPOSED MISSION FOR DIRECTORATE OF CONTRACT FINANCE POLICY

The jurisdiction and responsibilities of the Directorate should fall into five major functional areas. Each is described in detail below. The order in which the functional areas are presented does not necessarily represent their relative importance.

#### A. Support for Contract Finance Committee

The Directorate will work closely with the Contract Finance Committee. In so doing, the Director will take an active interest in the policy implications of some of the Committee's major cases.

Certain important cases presented to the Committee should receive an independent evaluation by the Directorate staff to aid the Chairman. Facts and figures submitted by the MILDEPs may be verified and analysis may be conducted to provide insight and guidance.

In addition, the Directorate's support staff will provide administrative assistance to the Committee when its workload becomes excessive and necessitates additional support. The Directorate will also assist, as needed, in processing changes through the ASPR Committee.

#### B. Provide Independent Analysis of Appendix E

It will be the responsibility of the Directorate to assist the Contract Finance Committee in the formulation and institution of changes to Appendix E to the ASPR. This will include a continuing review of Appendix E. This review will be carried out not in the context of a particular case, but rather to assess adequacy in a general sense. It should result in clear, complete, and up-to-date presentation of contract financing policy. Detailed instruction on how to carry out this policy must remain

with each of the MILDEPs. The Directorate will not recommend amendments as a result of individual case experiences, except in extraordinary circumstances.

C. Monitor Financial Condition of Defense Industrial Base

The directorate will provide for the continuous monitoring of the financial condition of the private sector companies which have been awarded major DoD contracts.<sup>5</sup> It is anticipated that twelve to fifteen companies will receive this in-depth financial coverage. The companies will be chosen by the Director on the basis of both the importance of their government contracts to the DoD and apparent corporate financial strength. An extremely strong company with a large contract might not require this continual financial scrutiny while a weaker company holding a somewhat smaller contract might be included. The actual monitoring of these companies can be performed either by the Directorate or by contract with an independent consulting firm knowledgeable in both procurement and financial analysis.

The Directorate also will provide for the maintenance of a computerized system of financial statement retrieval and analysis covering several hundred of the largest defense DoD contractors. This system will be made available for use by other appropriate DoD units as well as by the Directorate.

Finally, the Directorate will respond to all inquiries initiated by or channeled through OASD(I&L) on the financial condition of selected contractors or selected segments of the defense industrial base. This response should generally be readily available through the individual analysis of the largest contractors and the extensive data base of several hundred contractors described above.

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<sup>5</sup> Appendix C describes a system which could be used to fulfill this function.

D. Special Studies Initiated or Channeled Through the ASD(I&L) or DASD (Procurement)

From time to time, financial analyses of various parts of the defense industrial base will be conducted. When such studies are large and require additional personnel, the Directorate's staff should be augmented to prevent backlogs from occurring.

E. Respond to Issues Concerning Contract Finance Policy Between ASD(I&L) and Outside Groups

The Directorate serves as the liaison between OASD(I&L) and other defense and outside groups on the subject of defense contract finance policies. The Director will interact with other offices within DoD, such as the OASD(Comptroller), on issues concerning contract finance. Also, the Director will represent the DoD in interactions with other government groups such as the Office of Management and Budget, the Office of Federal Procurement Policy and Congressional Committees. Lastly, the Director will interact with private sector industry representatives on matters concerning the financing of defense contracts.

## APPENDIX B

### OTHER ORGANIZATIONAL ALTERNATIVES FOR CONTRACT FINANCE COMMITTEE

Among the many options considered for the reorganization of the Contract Finance Committee, several others deserve mention.

1. Decentralize the Authority of the Contract Finance Committee. Retain OASD(I&L) Policy Making

Under this alternative, each Service's powers would be expanded. All ASPR Appendix E deviations and changes would be recommended by the Service involved. The Directorate of Contract Finance Policy would exist, but not in relation to the Contract Finance Committee as suggested by the mission statement.

The key advantage of this arrangement is the closeness of the decision-making to the actual problems. Unrealistic abstraction is eliminated. Additionally, the position of Contract Finance Committee Chairman could be concentrated on other related OASD(I&L) (Procurement) problems full time. Finally, the MILDEPs would be clearly responsible for their problems.

On the other hand, OASD control would practically vanish. Checks and balances would be eroded. Fiscal discipline could be jeopardized. Finally, intricate coordination would be required between the Services and OASD(I&L) (Procurement).

2. Transfer the Contract Finance Committee to the ASPR Committee as a Standing Subcommittee

This alternative addresses the problems of administration. The ASPR Committee has full-time staff and space. It is a tightly controlled body of specialized subcommittees reporting back to a full ASPR Committee. This option would transfer all functions including most of the policy-making to the ASPR Committee.

Clearly, the most attractive feature of this alternative is the administrative effectiveness of the ASPR Committee. The rules and regulations are enforced and high standards are set for the subcommittee reports. OASD seems to provide an adequate allocation of resources for the efficient operation of the ASPR Committee.

On the other hand, the ASPR Committee does have a self-contained layering of authority between Services, subcommittees, and the full committee. This would be a real problem considering the urgency of many of the day-to-day financing problems that arise. Additionally, the full ASPR Committee would need extensive orientation to understand the complexities of financing problems.

3. Establish a High Level Staff of Civilian Analysts to Handle the Entire Area of Contract Financing

This alternative differs significantly from the current structure. The committee and the Directorate would be abolished in favor of a small group of professional staff members in OASD(I&L) (Procurement). The staff would operate full-time in contract financing. They would be backed by computer support and wide-ranging authority.

There is some attraction to the idea of eliminating the coordination problems of the Contract Finance Committee in its present size. Also, a group like this would presumably offer a high degree of objectivity as they would have no MILDEP loyalties.

However, it is unlikely that a group so removed from the real world of financing could be effective. Moreover, the all important procurement experience is likely to be missing among such a "whiz kid" type operation. Finally, this would require a major change in ASPR.

## APPENDIX C

### SUMMARY OF ANALYTIC SYSTEM FOR FOLLOWING SELECTED CONTRACTORS ON A CONTINUAL BASIS

The financial position of approximately ten to fifteen large defense contractors should be the subject of continuous in-depth analysis by the Directorate of Contract Finance Policy. While the names of these companies will undoubtedly appear regularly on the list of the top companies receiving the largest dollar volume of military prime contract awards, the criteria for this continuous coverage is not merely determined by the volume of government business alone. These contractors must have also demonstrated real or potential financial problems which could conceivably jeopardize the successful completion of DoD programs. Such problems could have been generated either from the firm's commercial business or from government business which did not produce the anticipated returns. The list of the companies to receive this continual financial coverage will be generated by the Director of the Directorate of Contract Finance Policy.

This continuous coverage of the financial status of selected contractors is thought to be necessary so that the DoD will have adequate information to deal with and minimize the effects of these potential problems. If the DoD is monitoring potential problem areas, steps can be taken to restructure contracts, adjust financing arrangements or take other actions which will hopefully avert significant disruptions to major programs. While it is clearly not anticipated that this financial analysis will be a major determinant in the award of contracts, it could affect the structure and post-award monitoring of these contracts.

The continuous coverage of these companies should consist of analysis of all relevant information published by the Company, the DoD and industry sources as well as frequent direct contact with management. It is anticipated that an analyst will visit each company

once a year for meetings with key members of the firm's management team. Additionally, frequent telephone conversations should be necessary to clarify and expand upon quarterly financial figures or other events affecting the company's financial position. These open lines of communication between the contractors and the Directorate's analysts should also allow for a greater facility in understanding and solving any problems which might arise.

The output from this continual coverage will be submitted directly to the Directorate of Contract Finance Policy where it can then be directed to other appropriate offices within DoD. This output should consist of: (1) in-depth reports issued once a year, (2) summary reports issued quarterly, and (3) special reports to be issued when the need arises. The yearly reports should be about as comprehensive as a routine annual report. The quarterly reports, to be issued after quarterly financial reports are published by the company, will basically update the in-depth annual report with relevant information from the latest fiscal quarter. The special reports would deal with a specific event and its consequences. In addition, other reports might be compiled on these companies in response to requests for specific information from appropriate DoD offices.

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